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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

In the Matter of the PUBLIC UTILITIES COMMISSION Instituting a Proceeding to Investigate the Issues and Requirements Raised by, and Contained in, Hawaii Revised Statutes Chapter 486H, as Amended	DOCKET NO. 05-0002

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PUBLIC UTILITIES COMMISSION

DIVISION OF CONSUMER ADVOCACY'S STATEMENT OF POSITION

DIVISION OF CONSUMER ADVOCACY
Department of Commerce and
Consumer Affairs
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DIVISION OF CONSUMER ADVOCACY'S STATEMENT OF POSITION

Pursuant to the purpose of this investigation set forth in Order No. 21525 and the regulatory schedule set forth in Order No. 21670, the Division of Consumer Advocacy ("Consumer Advocate"), files its Statement of Position in this proceeding.

I. INTRODUCTION.

A. PROCEDURAL HISTORY.

With Order No. 21525, dated January 4, 2005, the Public Utilities Commission of Hawaii ("Commission") instituted a proceeding in Docket No. 05-0002 to investigate the issues and requirements raised by, and contained in, Hawaii Revised Statutes 486H, as amended. Chevron U.S.A. Inc. ("Chevron"), Tesoro Hawaii Corporation ("Tesoro"), and the Consumer Advocate were made parties to the proceeding. With Order No. 21579, the Commission granted intervention in the docket to Shell Oil Company ("Shell") and the Hawaii Petroleum Marketers Association ("HPMA").

ICF Consulting ("ICF") was engaged by the Public Utilities Commission to assist in reviewing and evaluating the issues and requirements raised by and contained in the Gas Cap Law (HRS 486H), and to make implementation recommendations. From February 2 to April 11, 2005, the Commission issued information requests to the parties. On April 18, 2005, ICF submitted its report, Implementation Recommendations for Hawaii Revised Statutes Chapter 486H, Gas Cap Price Legislation ("ICF Report").

The Commission conducted statewide public meetings in the beginning of May 2005 to solicit comments from the public. In addition, ICF conducted technical meetings with the parties on May 18 and 19, 2005. Information requests were issued to ICF on May 27, 2005 and responses were provided on June 20, 2005.

B. BACKGROUND.

Responding to a perceived lack of competition in wholesale gasoline markets, the Hawaii Legislature has passed legislation to regulate the wholesale price of gasoline in Hawaii effective September 1, 2005. The overall approach of the legislation is to impose a price ceiling on wholesale gasoline prices that reflects competitive market conditions. The legislative intent is essentially to establish a regulated process as close to "free market" as possible. As noted by the Legislature, it is not the intent of the Gas Cap Law to guarantee lower gasoline prices in Hawaii; rather its objective is to enhance consumer welfare by fostering the opportunity for prices to reflect and correlate with competitive market conditions.

ICF Consulting was engaged by the Public Utilities Commission to assist in reviewing and evaluating the issues and requirements raised by and contained in the

Gas Cap Law (HRS 486H), and to make implementation recommendations. The Consumer Advocate engaged MJ Ervin & Associates Inc. as a qualified consultant to assist it in reviewing and evaluating the issues presented in this docket. MJ Ervin & Associates Inc. has been providing specialized consulting services relating to the downstream petroleum sector in Canada since 1991, and is uniquely qualified to assist the Consumer Advocate in this matter. Their consulting focus is specific to the petroleum marketing industry, and they have particular expertise in matters pertaining to retail gasoline marketing, infrastructure and pricing. A considerable amount of their experience and expertise relates to regulated gasoline markets in Canada which instituted retail petroleum price controls in Newfoundland and Labrador in 2001.

II. DISCUSSION.

In Order No. 21525, the Commission set out the non-inclusive list of issues and requirements to be examined as follows:

1. Examining the effect, impact, and appropriateness of the baseline price as defined in HRS §486H-13(c), as amended, and examining options as to a more appropriate baseline or a more appropriate reporting service, if any.
2. Examining the effect, impact, and appropriateness of the location adjustment factor as defined in HRS §486H-13(d), as amended, at $0.04 per gallon, and examining options as to a more appropriate location adjustment factor, if any.
3. Examining the effect, impact, and appropriateness of the marketing margin factor as defined in HRS §486H-13(e), as amended, at $0.18 per gallon, and examining options as to a more appropriate marketing margin factor, if any.

4. Examining the effect, impact, and appropriateness of the mid-grade adjustment factor established in HRS §486H-13(f), as amended, at $0.05 per gallon, and examining options as to a more appropriate mid-grade adjustment factor, if any.

5. Examining the effect, impact, and appropriateness of the premium adjustment factor established in HRS §486H-13(g), as amended, at $0.09 per gallon, and examining options as to a more appropriate premium adjustment factor, if any.

6. Determining the types of documents, data, and information manufacturers, wholesalers, or jobbers must furnish to the commission to make determinations on zone price adjustments. HRS § 486H-13(h), as amended.

7. Analyzing zone price adjustments to the maximum pre-tax wholesale regular unleaded, mid-grade, and premium gasoline prices and examining the effect, impact, and appropriateness on a zone by zone basis. HRS § 486H-13(i), as amended.

8. Determining the types of documents, data, and information necessary for the Commission to determine whether the manufacturer, wholesaler, or jobber is complying with any requirement imposed or rule adopted, pursuant to HRS Chapter 486H. HRS § 486H-13(j), as amended.

9. Identifying any further adjustments necessary to establish maximum pre-tax wholesale gasoline prices that reflect and correlate with competitive market conditions. HRS § 486H-16(c).

A. ICF REPORT AND RECOMMENDATIONS.

Overall the ICF report, "Implementation Recommendations for Hawaii Revised Statutes Chapter 486H, Gas Cap Price Legislation" ("ICF Report"), appears to be professionally competent. In our view, however, there are opportunities for the Commission to make changes/enhancements to ICF's recommendations that will help the Commission meet its obligation to implement the Gas Cap Law effectively while protecting stakeholder interests including the public, government, and petroleum marketers.

As noted by ICF, the "legislation as enacted incorporates the key steps in building up to a competitive market based price for wholesale gasoline." (ICF Report at 1) ICF recommended, however, that components should be modified to better reflect the competitive market price in the baseline source cost of gasoline, the location adjustment (freight cost), marketing margins, and adjustments to marketing margin for premium and mid-grade gasoline. Id. ICF further recommended that the Commission adjust the marketing margin to recognize the multiple levels of trade in wholesale gasoline marketing. Id. In all, the ICF Report recommends setting 96 different caps on a weekly basis, for three grades of gasoline (Premium, Mid-grade and Regular) in four classes of wholesale trade (Dealer Tankwagon ("DTW"), Rack (Branded and Unbranded), and Bulk)[1] in eight unique zones across the State of Hawaii. (ICF Report at 68)

1. "Import Parity" or Baseline Plus Location Adjustment.

ICF recommended that the baseline price of gasoline contained in HRS § 486H-13(c) should be modified from the US Mainland price points (Los Angeles, New York, and the US Gulf Coast), to reflect what ICF believes are the most likely alternative source points for gasoline into Hawaii - the Far East and Caribbean markets (ICF Report at 17-19). Based on ICF's analysis of 1999-2004 data, this recommendation would result in a baseline price for gasoline about 8.5 cents per gallon (cpg) lower than use of the U.S. mainland price points.

ICF also recommended that the location adjustment factor proposed in HRS § 486H-13(d) be modified from a fixed 4 cpg to a factor which varies weekly based on the freight market for gasoline cargoes. (ICF Report at 20-22) ICF found that the location factor proposed by the legislature was extraordinarily low based on the historical information evaluated. Id. ICF estimated that the use of the location factor

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1 Definitions:

DTW (Dealer Tankwagon)	the price that the dealer pays to its supplier, usually a jobber or refiner. Dealer prices are usually higher than rack prices because they include transportation costs. A tankwagon is the actual vehicle that the supplier or jobber uses to transport product to the dealer.
Rack	Petroleum products sold at the wholesale level from primary terminal storage. Refers to loading racks where tanker trucks fill up.
Branded	A specific supply arrangement with a supplier that markets a specific brand. The supplier is usually contractually obligated to sell a specific amount of product to the reseller.
Bulk	Wholesale sales of gasoline in individual transactions which exceed the size of a truckload.

from the ICF proposed baseline sources (Far East and Caribbean) in calculating a weekly location adjustment factor based on cargos, would have resulted in an average 7.5 cpg higher location adjustment than the 4 cpg included in 486H-13(d). Id.

Together, ICF's recommended baseline and location adjustment factors are intended to represent the cost of delivering gasoline into Hawaii. This "import parity" price, would be calculated on a weekly basis and is intended to reflect the cost an importer would need to pay to import gasoline into Oahu to compete with the local gasoline supply. (ICF Report at 2).

2. Marketing Margins.

ICF concluded that the various classes of wholesale trade (bulk, rack, and DTW) cannot be regulated under one common margin. (ICF Report at 2). In addition, ICF recognized that there can often be multiple wholesale transactions prior to delivery to a service station and concluded that the wholesale price must be high enough to cover the cost of the product and the cost of marketing. In its analysis ICF relied on Mainland margins and indicated that it also incorporated cost data provided by Hawaii suppliers that may be higher than Mainland costs. ICF recommended that the marketing margins be evaluated and updated annually based on its methodology. (ICF Report at 29-47).

3. Premium and Midgrade Adjustments.

The adjustment factors proposed in HRS § 486H-13(f) for Mid-grade and Premium gasoline were close to results based on ICF's analysis for gasoline sales on a

DTW basis. ICF also recommended in its report adjustments for Bulk and Rack classes of trade and a review and update of the factors annually. (ICF Report at 49-58).

4. Zone Price Adjustments.

HRS 486H-13 divided the State to eight (8) zones which included Oahu, the five (5) neighbor islands, splitting the Big Island to two zones and the separation of Hana from the island of Maui. The legislation provides for a cost adjustment to transport gasoline from the source base of Oahu to the specific zones on the Neighbor Islands. Based on information provided by the parties, ICF determined zone adjustments by zone for barge, terminal costs, and trucking costs. (ICF Report at 61-64).

5. Documentation and Processes.

In its report (Section 7), ICF identified documents required to develop market based Gas Caps and to evaluate wholesale marketers' compliance with the caps. In addition, ICF outlined the process to develop and calculate the Gas Caps. ICF emphasized that the timing of the weekly publication of the caps was very critical and suggested possible approaches.

B. ADJUSTMENTS TO ICF REPORT RECOMMENDATIONS.

Subsequent to ICF's Report and technical meetings with the parties, ICF, in response to CA-IR-1, recommended several departures from the recommendations in its report. These included:

1. ICF would include an inventory carrying cost in the import parity calculation based on an additional three week supply held "on the water". This cost would float with baseline prices, and would be about 0.35 cpg in today's market.
2. ICF would recommend an adjustment to the marketing margins to reflect relative land value and rent caps in Hawaii vs the Mainland markets evaluated in the ICF Report. Determination of this factor would require further data and analysis than ICF had for the report.
3. ICF would recommend not imposing gas caps on the Bulk class of trade.
4. ICF would consider, with Parties' endorsement, eliminating the Unbranded Rack class of trade.
5. ICF would incorporate an adjustment for potential increases in the Panama Canal fees, import duties, etc when those may change.
6. ICF would correct Exhibit 4.11 by utilizing all non-rounded results.
7. ICF would correct tariff assumptions for Rack margins in Atlanta and terminaling costs in Phoenix, which both were understated by 1 cpg. ICF would also evaluate Seattle margins using the Portland spot market in lieu of the Seattle barge market as a cost basis.

C. RISKS PRESENTED BY REGULATION.

In gasoline markets consumer welfare is a not only a function of competitive market-driven prices, but also of surety of convenient supply and choice. According to ICF, "the impact of conducting business within the Cap framework may result in some significant re-evaluation of assets and business by industry participants". (ICF Report at 73). Assuming this is true, there will no doubt be consequent impacts on consumer welfare. The imposition of Gas Caps generally, and the specific implementation recommendations in the ICF report, could have some unintended consequences, including but not necessary limited to:

1. Increased Risk of Gasoline Supply Shortages.

ICF recommends the baseline price of gasoline stated in 486H-13(c) be modified from US Mainland price points to reflect the most likely alternative source points for gasoline into Hawaii, namely the Far East and Caribbean markets. (ICF Report at 5). Historic analysis indicates that the proposed ICF basket (comprised of a 50/50 split Singapore and Caribbean sourced imports) would have resulted in a baseline price 8.5 cpg lower than the original Legislative recommendation for the period 1999 to 2004. (ICF Report Exhibit 2.3). There may be instances when the proposed import parity price is lower than a local refiner's export opportunity, making it more attractive for refiners to export gasoline than sell it in Hawaii. The number of instances where the import parity price is lower than the export opportunity is likely to be greater under the ICF recommendation than it would be under the original Legislative recommendation, given the proposed source price is likely to be lower based on historical data. A price spike in West Coast markets resulting from a supply disruption in those markets would increase the motivation for a Hawaii refiner to export their production to the West Coast markets where prices are high and product is short. This could result in statewide gasoline shortages in Hawaii. ICF did not consider or analyze the impact of the price cap when the proposed import parity price is lower than a local refiner's export opportunity (Shell-IR-9).

2. Increased Risk of a Refinery Closure.

ICF recommends that the marketing margin factor stated in 486H-13(e) be modified to reflect their belief that the different wholesale classes of trade cannot be regulated under one common margin. (ICF Report at 2). The margin caps proposed by ICF range from 1 cpg above import parity for Bulk sales, to 15 cpg above import parity for DTW sales. Based on historical analysis, the wholesale margin caps proposed by ICF are likely to directionally reduce wholesale gasoline prices in Hawaii. ICF estimates that the Gas Caps would have reduced Oahu unleaded gasoline prices by about 13 cpg for Rack sales and 10 cpg for DTW sales based on 1999 to 2004 historical data. (ICF Report at 5). The lower wholesale prices will have a negative impact on the profitability of integrated refiner-marketers. The economic viability of the State's refiners would be threatened if they were unable to generate an adequate return on investment. On page 6 of their report, ICF states their belief that "it is important to Hawaii's long term energy security that the two refineries in Hawaii be financially sound." Not only would a refinery closure significantly increase Hawaii's reliance on petroleum product imports, directionally raising prices, it would have significant implications with respect to employment, capital investment, and potentially other impacts on the Hawaii economy. ICF has not analyzed refiner profitability (Chev-IR-1) but acknowledges that the possibility of reduced profits resulting from the Gas Caps in combination with the impacts of mandated ethanol legislation in 2006 may push Hawaii's refiners to carefully examine refinery profitability and sustainability (ICF Report at 74), and that the implementation of the Gas Cap law as recommended could lead to an increased risk of a Hawaii refiner closing its Hawaii business. (Shell-IR-76).

3. Increased Risk of Wholesale Marketers Deciding to Cease Operations.

ICF states that wholesale marketers who buy product on a bulk basis from refiners, or refiners who market on a wholesale basis, are likely to see the greatest impact from the Gas Cap legislation. (ICF Report at 75). By definition the Gas Caps will limit the price that wholesale marketers can secure from their Rack and DTW customers. Based on historical analysis, there could be a substantial reduction in wholesale gasoline margins under the proposed price caps. For example, the 2005 unleaded DTW margin cap in Oahu would be 15 cpg (based on ICF's recommendation of double the average 2004 DTW margin in select Mainland markets). This would represent a 43 percent reduction relative to the average margin for the five-year period from 1999 to 2004. (ICF Report Exhibit 3.16). The 2005 unleaded Rack margin cap in Oahu would be 6.7 cpg (based on ICF's recommendation of double the average 2004 Rack margin in select Mainland markets). This would represent a 65 percent reduction relative to the average margin for the five-year period from 1999 to 2004. (ICF Report Exhibit 3.11). If the proposed price caps do not cover wholesale marketing costs (including truck delivery for DTW class of trade) and provide a reasonable profit margin, some wholesale marketers may choose to cease operations, with the consequence of reducing, rather than increasing wholesale competition in Hawaii. ICF points out that wholesale marketers in Hawaii, like refiners, will likely have to examine business costs and margins in a regulated market, and given the relatively small number of suppliers in Hawaii, the attrition of any marketers due to the Gas Cap impact needs to be quickly understood to minimize supply issues to consumers. (ICF Report at 75).

4. Increased Risk of Smaller, Remote Stations Losing Supply.

The legislation defined in 486H-13 provides for a zone adjustment to cover the costs associated with transporting gasoline from the source base in Oahu to seven specific outer zones and to store the product in the outer zones. These costs include the cost to barge product to the zones, terminal costs for product storage and handling, and trucking costs to deliver product to the retail customer for DTW sales. ICF's overall approach to establishing the zone adjustments was to collect actual cost data from the parties and to average these data to arrive at "typical" barge, terminalling, and truck costs. ICF acknowledges that using an industry average cost will benefit some suppliers and penalize others. (ICF Report at 3). ICF further states that the actual costs of operation will not be the same for all sales within a zone, as evidenced by the fact that data from companies indicate spreads from 1 cpg to 8 cpg or higher. (HPMA-IR-24). Given this range, there will be situations where the cost to supply a station will be higher than the zone average. In a capped price environment, a wholesale marketer supplying a DTW account may see no way to cover their costs to service the account and may cancel the supply contract. ICF anticipates the possibility of some service station closures in some areas due to supply cost issues, and that there is a higher risk that remote locations might lose service. (HPMA-IR-34, CA-IR-12). ICF did not analyze or quantify the potential for remote stations losing supply, but concurs that it would be reasonable and prudent to consider these impacts prior to implementation of the Gas Caps. (Shell-IR-78).

5. Increased Risk of Reduced Investment.

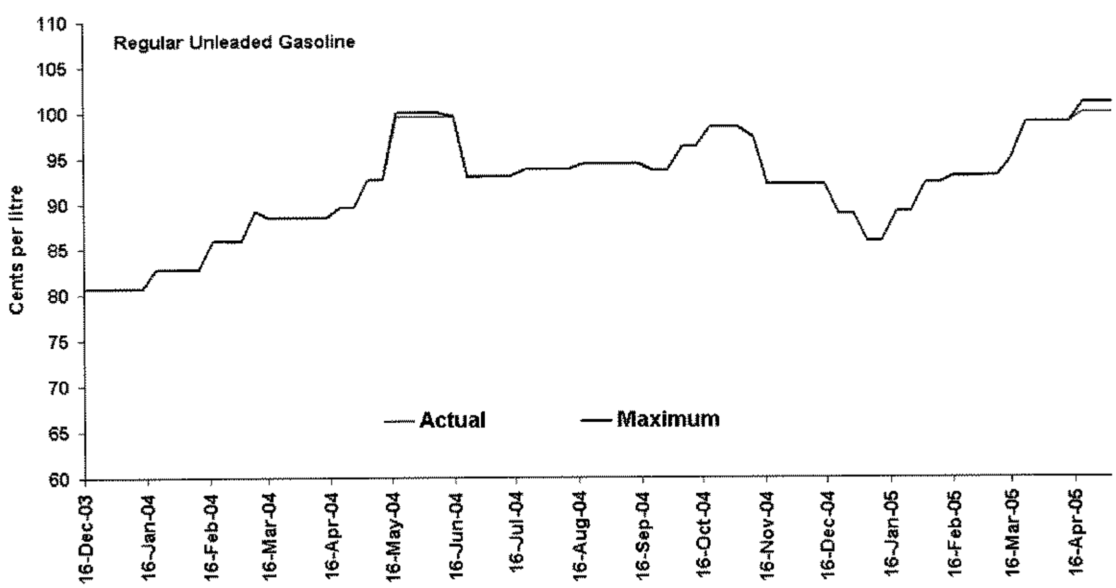
The overall approach taken by ICF to manage wholesale margins within Mainland benchmarks fundamentally fails to acknowledge the need for refiners-marketers to earn an acceptable return on capital employed. The petroleum industry is extremely capital intensive, from the cost of refineries, to capital tied up in inventories and receivables and the cost of retail stations. To the extent that a price ceiling is restrictive, it is likely to discourage investment. One of the market implications of imposing a regulated price ceiling is reduced local investment if a better return can be obtained elsewhere. Petro-Canada, one of the largest petroleum refiner-marketers in Canada, divested its retail marketing presence in Newfoundland and Labrador in 2002, shortly following that province's implementation of a retail petroleum price ceiling. It is possible this decision may have, at least in part, been driven by the Newfoundland regulation.

6. Risk of Price "Signaling."

Experience with other regulated regimes points to the fact that marketers will tend to set prices at the cap, even when market conditions are such that the capped price is above what a market-based price would be. Newfoundland and Labrador began regulating petroleum pump prices in 2001. The regulatory mechanism in Newfoundland and Labrador is essentially a "price cap" structure, where the Petroleum

Pricing Office, an office operated by the Public Utilities Board of Newfoundland and Labrador, uses a formula to determine maximum allowable retail pump prices on a monthly basis. Since the introduction of retail price caps, actual pump prices in St. John's, the capital of Newfoundland and Labrador, have been set at the maximum allowable price almost without exception. (See Exhibit 1). While marketers have the authority to set their prices below the regulated maximum, the only occasions they have elected to do so was when the maximum price exceeded the psychological threshold of one dollar per litre. The pricing behavior of marketers in Newfoundland and Labrador points to the fact that the regulated maximum price may be acting as a price signal to retail marketers.

Exhibit 1: St. John's Actual Pump Price Versus Maximum Pump Price



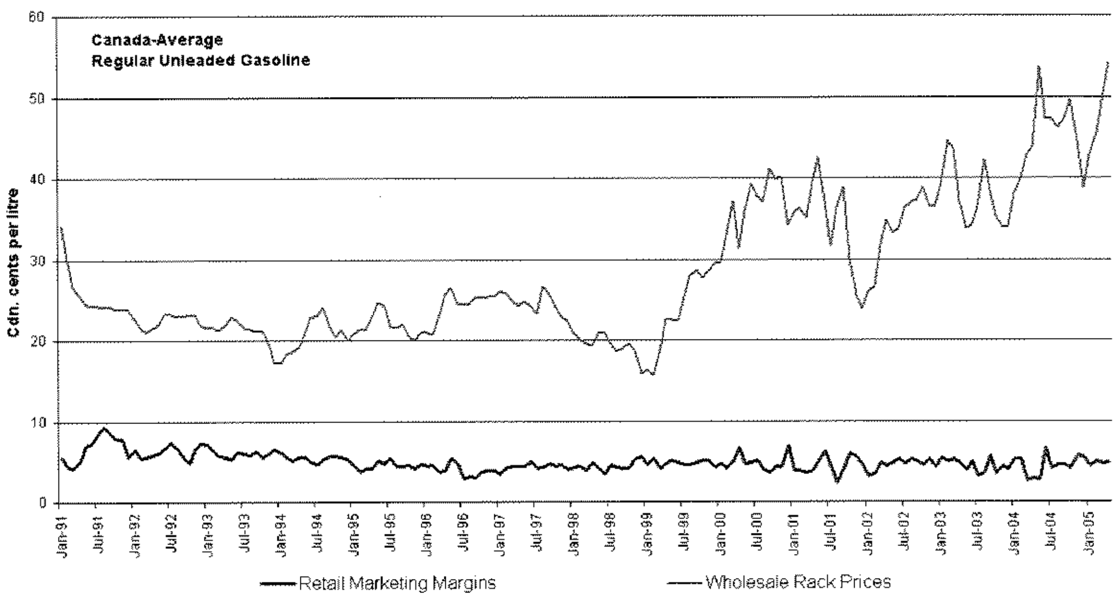
In Hawaii, the risk associated with the possibility of price signaling is exacerbated by ICF's overall approach of doubling mainland margins in the price cap calculation. ICF's rationale for doubling the Mainland margins is that typical "peak" margins can at times be roughly double the annual average. (ICF Report at 36). If the wholesale price caps in Hawaii are used as target prices, by definition, margins in Hawaii will be twice as high as in Mainland benchmark markets.

7. Risk of Profits Flowing from Wholesalers to Retailers.

The price cap legislation affects wholesale gasoline prices only, and retail marketers are therefore under no obligation to lower pump prices if wholesale prices are reduced.

The retail petroleum market in Canada, like Hawaii, is characterized as being highly competitive. An analysis of historic data in Canada over the past fifteen years shows that fluctuations in retail gasoline prices (excluding taxes) have followed very closely upward and downward changes in the underlying wholesale rack prices. That is to say that retail marketers in Canada have increased pump prices with increases in wholesale prices, and lowered retail prices when wholesale prices are reduced. As a consequence, rack-to-retail marketing margins have been extremely stable relative to wholesale rack prices as evidenced in the Exhibit 2 below.

Exhibit 2: Retail Marketing Margins Versus Wholesale Rack Prices



In our view, the risk of retailers not passing on lower wholesale prices to the retail level is minimal, based on experience in Canadian petroleum markets and the fact that Hawaii retail petroleum market, as opposed to the wholesale petroleum market, has been characterized as highly competitive.

While as noted, ICF Consulting explicitly identified most of these impacts in their report, or acknowledged them in their responses to Information Requests, the impacts have not been closely examined or quantified.

D. ETHANOL BLENDING MANDATE

Compounding the uncertainty of the Gas Cap impacts are state ethanol blending mandates that go into effect in April 2006. At p. 76 of their report, ICF notes that

> the intent of this report was not to identify the issues or impacts of ethanol blending; however it is clearly a factor which may need to be considered by the Commission in future Gas Cap management.

In their response to party Information Requests (HPMA-IR-38) ICF expressed concerns that

> ..the marketers, refiners, and consumers in Hawaii may be approaching a confluence of regulatory actions involving both the gas caps and ethanol which will likely create high business and capital investment uncertainty, as well as possible supply concerns.

ICF further stated that the uncertainty of the costs and ability to initially acquire and blend ethanol from outside Hawaii is a greater challenge and issue than the gas caps.

E. ALTERNATIVES TO STRICT ENFORCEMENT OF THE PRICE CAPS

In various responses to information requests (see CA-IR-1, CA-IR-12, and HPMA-IR-39), ICF indicated that the Commission might consider implementing the law on a purely "calculation and monitoring" basis, rather than strictly enforcing the law. Given the possible unintended consequences and risks associated with the implementation of the Gas Caps coupled with the lack of understanding regarding the issues and impacts of the ethanol mandate, the Consumer Advocate would consider supporting such a system to provide additional time and information to better assess the impacts of the regulation. However, the Consumer Advocate does not believe that the law allows for only a "calculation and monitoring" system without a change in the Gas Cap Law. This, of course, is beyond the Commission's authority. While the Commission, which has discretion in deciding whether to bring a civil action under HRS § 486H-13(l) to collect penalties for violations of the law, could choose not to do so, it is the manufacturers, wholesalers and jobbers that bear the risk of not complying with the law. The Consumer Advocate does not suggest to anyone that non-compliance is or can be acceptable under the present law.

Regardless, in our view, a monitoring and publication approach affords a number of benefits including:

1. Providing the opportunity to develop an understanding of the costs associated with the ethanol mandate including capital investments, storage, and transportation.
2. Providing more time to understand the small marketer impacts.
3. Providing the opportunity to watch the model in motion and to identify and correct glitches.
4. Allowing regulators to develop an understanding of where reality departs from the model and to make the necessary adjustments.
5. Creating price transparency, which if done properly can arguably be as effective as price caps.
6. Identifying variances between actual prices and nominal caps and promotes discussion regarding rationale.
7. Providing the opportunity for reduced administrative complexity and consequent cost savings.
8. Enabling stakeholders to become more familiar with the issues and determine the long term need for caps.

The Consumer Advocate shares ICF's view that the "publication of the gas caps and the ongoing monitoring and publication of wholesale and retail prices can provide a significant share of the benefits of a rigorous compliance system, and may merit consideration by the Commission prior to a full gas cap implementation." (HPMA-IR-39) Until and unless the law is changed, however, manufactures, wholesalers and jobbers should comply with its provisions.

III. RECOMMENDATIONS

A. ADJUSTMENTS TO ICF REPORT RECOMMENDATIONS

In the context of and in addition to the above, the Consumer Advocate recommends and agrees that the following adjustments to ICF Consulting's recommendations for the implementation of Hawaii Revised Statutes, Chapter 486H, the Gasoline Price Cap Legislation:

1. Import Parity Calculation

ICF's recommendation for the baseline source price for gasoline does not consider the inventory carrying costs associated with importing gasoline into Hawaii in its import parity calculation (Tesoro-IR-12). ICF acknowledges that the additional volume of gasoline "on the water" should be considered in the import assessment. (Tesoro-IR-12).

Recommendation: The Consumer Advocate agrees that the import parity price calculation should include an inventory carrying cost based on an additional three-week supply held "on the water". This cost would float with baseline prices, and would be about 0.35 cpg in today's market according to ICF. (Tesoro-IR-12).

ICF's freight assumptions associated with product imports sourced in the Caribbean include an estimate of canal fees. (ICF Report at 22). These canal fees are subject to change, however, ICF's recommendations did not provide for updating these fees in their report. (HPMA-IR-5).

Recommendation: The actual Canal Fees associated with Caribbean volumes should be reviewed and updated annually.

2. Marketing Margin Calculation.

ICF recommends, "that Bulk sales from refineries in Oahu be limited to the calculated import parity pricing, plus 1 cpg to provide a margin incentive for importing". (ICF Report at 34). The parties have identified several issues associated with the imposition of a bulk sales cap (Chevron-IR-25 and CA-IR-8):

- The cap does not recognize, or make allowance for, multiple bulk sales. That is to say there would be no margin available beyond the first bulk sale. Multiple bulk sales do take place in Hawaii according to the Parties.
- Assigning a cap to the bulk class of trade is likely to cause pricing anomalies and legal problems with existing contractual agreements. Additionally, in ICF's opinion the bulk sales cap would not further the intent of the Gas Cap legislation (CA-IR-8). In consideration of these issues ICF states in response to CA-IR-8 they would recommend not imposing a gas cap on the Bulk class of trade.

Recommendation: The margin cap on the Bulk class on trade should be eliminated.

ICF reviewed historical pricing behavior in Mainland markets and found that Unbranded prices mirror closely the Branded prices but that on occasion Unbranded prices will invert above Branded prices, presumably to assist in managing supply and demand. (ICF Report at 39). Based on their analysis of behavior on Mainland markets, ICF recommends the Gas Cap formula in Hawaii should recognize that at times it might be necessary to have the Unbranded gasoline cap higher than the Branded gasoline cap. However, according to the parties, not only is the Unbranded market in Hawaii small relative to the Mainland, it does not behave in a similar manner to the Mainland (Unbranded prices do not invert above Branded prices in Hawaii).

Recommendation: If the above is confirmed, the Consumer Advocate recommends that the margin cap on the Unbranded class of trade should be eliminated.

ICF's overall approach to Rack and DTW caps call for a doubling of the average annual margins in selected Mainland markets to account for the fact that typical peak margins on the Mainland can be about double the annual average. ICF believes that the Hawaii Gas Cap for Rack based and DTW sales should reflect peak margin limits to permit Hawaii wholesalers to use pricing strategies consistent with the Mainland and to achieve an average margin comparable to the Mainland. (ICF Report at 37-39). There is however a risk associated with this approach if wholesale marketers use the Price Caps as a target or signal price. If marketers continually price at the cap, then margins in Hawaii would be double the previous year's average in the selected Mainland benchmark markets.

Recommendation: The Commission should consider using a rolling-average Mainland margin that provides for a more real-time reflection of Mainland margins, but also provides consumers in Hawaii with some protection from the seasonality/volatility that exists in Mainland margins and mitigates the risk associated with the "doubling" approach proposed by ICF.

The Mainland rack margins used in ICF's analysis are gross margins and do not reflect Temporary Competitive Allowances (TCAs) or cash discounts. (Shell-IR-39). ICF acknowledges these discounts do take place, although not for all marketers and not consistently. ICF believes that estimating the level of discounting would be problematic to do with credibility and has therefore not accounted for these discounts in their recommendations. (Shell-IR-33). Ignoring these discounts results in an understatement of Mainland rack margins, which in turn will be imposed on Hawaii rack marketers by way of the price cap formula.

Recommendation: The Rack margin cap should be adjusted to reflect the Commission's best estimate of the impact on TCAs in Mainland markets.

ICF acknowledges (CA-IR-1) that the tariff assumptions in Atlanta and terminaling costs in Phoenix used in their calculation of wholesale rack margins in Mainland markets was understated by 1 cpg. (ICF Report Exhibit 3.9).

Recommendation: The historical wholesale rack margins should be recalculated to reflect the correct tariffs and terminaling cost.

ICF further recommends (CA-IR-1) that the Seattle rack margin should be evaluated using the Portland spot market in lieu of the Seattle barge market as a cost basis. (ICF Report Exhibit 3.9).

Recommendation: Evaluate the Seattle rack margin using the Portland spot market as the basis.

B. POSSIBLE FUTURE ADJUSTMENTS.

While some of the adjustments suggested seemed reasonable, insufficient data have been collected or made available to determine with any degree of accuracy specific margin adjustments. For instance, rent caps and land values are two fundamentally different aspects in Hawaii as compared to the Mainland markets selected to determine ICF's proposed Rack and DTW market-based margins. To the extent that these costs do not exist in those Mainland markets, the margin caps in Hawaii should be adjusted to reflect these fundamental differences. While ICF stated that it did not have adequate information to determine an appropriate margin adjustment at this time (see ICF Response to Chevron-IR-30), the law provides for future adjustments.

Section 486H-16, HRS, allows a manufacturer, wholesaler or jobber to petition the Commission to make adjustments to the various elements of the price caps, or for the Commission to, in its discretion, make adjustments deemed necessary to establish maximum prices that reflect and correlate with competitive market conditions.

Recommendation: The Consumer Advocate recommends that the Commission continue to gather information pertaining to possible reasonable adjustments and either upon its own initiative or upon being petitioned, consider making adjustments to reflect the costs of rent caps that do not exist in the Mainland markets evaluated and to reflect the relative land value in Hawaii versus the Mainland markets evaluated. (see generally ICF Response to Chevron-IR-33).

C. GAS CAP COMPLIANCE DATA REQUIREMENTS.

ICF recommends a highly complex web-enabled database to house actual wholesale transactions for comparison to regulated wholesale price caps by grade, by class of trade, and for each zone. (ICF Report at 68). ICF considered the alternative of a customer exception report or complaint process, but believes that the "data collection system provides the most thorough method to assure compliance." (Tesoro-IR-60). It does not appear that ICF provided a thorough analysis of compliance options.

The complexity of ICF's proposed system, and the volume of information that must be put into it, make it unlikely that such a web-enabled database can be designed, tested, and ready to receive the necessary inputs from industry to be an effective means to monitor transactions and supply the necessary information for enforcement of the law by September 1, 2005. Until such a system can be put into service (and the industry educated regarding how to use it), the default compliance mechanism will of necessity be the reporting of violations by customers.

While such a customer complaint mechanism is certainly less expensive, and may have other benefits, using it alone could also presents risks. For example, a remote retailer may be unwilling to report a violating supplier if doing so may eliminate his supply.

Recommendation: The Commission should complete an assessment of the relative costs and benefits of the proposed transactional database versus a customer complaint process.

IV. CONCLUSION.

The issues and information presented in this docket are complex and require careful consideration and analysis. Through it all, the Consumer Advocate believes that the interests of consumers (i.e., all the people of Hawaii) must remain paramount. While affordable and reasonable prices are certainly in the consumers' interest, of equal importance is the reliability of the resource. The regulation of wholesale gasoline prices is a first in this country, and the risks outlined above are just that - risks. They are not certain to happen.

The Consumer Advocate urges all regulators, administrators, and policymakers, who deal with this law to remain vigilant, open-minded, and willing to make any necessary changes or adjustments that may prove to be necessary to protect the interests of the people of Hawaii.

DATED: July 1, 2005. Honolulu, Hawaii,

Respectfully submitted,

By John E. Cole
JOHN E. COLE
Executive Director

DIVISION OF CONSUMER ADVOCACY

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing **DIVISION OF CONSUMER ADVOCACY'S STATEMENT OF POSITION** was duly served upon the following parties, by personal service, hand delivery, and/or U.S. mail, postage prepaid, and properly addressed pursuant to HAR § 6-61-21(d).

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